

OPEN MEETING AGENDA ITEM  
BEFORE THE ARIZONA CORPORATION COMMISSION



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AZ CORP COMMISSION  
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IN THE MATTER OF THE APPLICATION OF )  
LAS QUINTAS SERENAS WATER CO., AN ) DOCKET NO. W-015834-13-0117  
ARIZONA CORPORATION, FOR (i) A )  
DETERMINATION OF THE FAIR VALUE OF )  
ITS UTILITY PLANT AND PROPERTY AND (ii) ) LAS QUINTAS SERENAS WATER  
AN INCREASE IN ITS WATER RATES AND ) CO.'S EXCEPTIONS TO  
CHARGES FOR UTILITY SERVICE BASED ) RECOMMENDED OPINION AND  
UPON SUCH DETERMINATION ) ORDER

Pursuant to A.A.C. R14-3-110(B) and the February 25, 2014 Memorandum from the Commission's Executive Director transmitting Administrative Law Judge Belinda A. Martin's Recommended Opinion and Order ("ROO") in the above-captioned and above-docketed proceeding ("Instant Proceeding"), Las Quintas Serenas Water Co. ("LQS") hereby submits its Exceptions to the ROO.

I.

INTRODUCTION

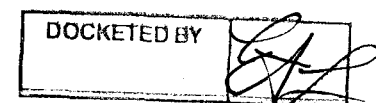
LQS and the Commission's Staff are the only parties to the Instant Proceeding. As a result of pre-hearing exchanges of pre-filed prepared testimony and discovery, LQS and the Commission's Staff were able to reach agreement in a number of areas with respect to LQS' request for an increase in its rates and charges for water service. Illustrative of this fact is the following observation within the ROO:

"The remaining contested issues in this proceeding are [i] the professional services expense, [ii] rent expense, [iii] the cost of equity, [iv] revenues and [v] rate design." [ROO at page 4, lines 24-25]

Arizona Corporation Commission

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MAR 06 2014



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1 In its Exceptions, LQS will discuss why the ROO's recommended manner of resolution of issue(s)  
2 (ii) through (v) above is unlawful, unfair and/or inadequate.<sup>1</sup> In addition, these Exceptions will  
3 also explain how Commission adoption of the ROO recommendations here under discussion  
4 would adversely impact LQS' ability to attract capital and LQS' revenue stability.

5 II.

6 DISCUSSION

7 A. The ROO's Recommended Resolution of the "Rental Expense" Issue Fails to Take  
8 Into Account LQS' Actual Financial Circumstances.

9 The ROO correctly recognizes that in its Decision No. 69380 the Commission found that a  
10 back-up generator was necessary for system reliability on LQS' water system, and therein the  
11 Commission authorized LQS to borrow \$400,714 from the Arizona Water Infrastructure Financing  
12 Authority ("WIFA") to cover the cost of installing a 400,000 gallon storage tank and purchasing  
13 the back-up generator.<sup>2</sup> That is because the cost of the arsenic treatment facilities authorized in  
14 Decision No. 68718 and the additional storage which was the subject of Decision No. 69380  
15 proved to be more expensive than the amounts originally projected for purposes of each WIFA  
16 loan. As a consequence, LQS made arrangements with its majority shareholder, Freeport-  
17 McMoRan Sierrita, Inc. ("FMS") for the use of a 100 kW portable generator; and, for several  
18 years, FMS made the generator available to LQS at no cost.

19 However, in anticipation of the Instant Proceeding, LQS and FMS concluded that LQS  
20 should request ratemaking recognition of an annual rental amount for the generator, since but for  
21 FMS' willingness to make the same available, LQS would need to either purchase or lease an  
22 equivalent generator from a third party at a higher cost. Stated differently, inasmuch as the Instant  
23 Proceeding is intended to establish rates and charges for LQS moving forward which will enable it  
24 to recover its costs of doing business (as well as providing a fair rate of return on its investment),  
25

26  
27 <sup>1</sup> The ROO recommends resolution of the "professional services expense" issue in the manner proposed by LQS, and  
28 thus that issue is not addressed in these Exceptions.

<sup>2</sup> ROO at page 7, lines 18-21.

1 those rates and charges should include ratemaking recognition of the cost of renting a portable kW  
2 generator suitable for LQS' system needs.

3 The ROO correctly provides for a measure of such ratemaking recognition. However, the  
4 rationale adopted for quantifying the ratemaking recognition is inappropriate, given LQS' actual  
5 financial circumstances, and the resulting amount is inadequate.

6 More specifically, the methodology adopted by the ROO presupposes that LQS either  
7 currently has or, as a consequence of the increase in rates and charges recommended in the ROO,  
8 will have sufficient funds available to it for the sole purpose of purchasing a portable 100 kW  
9 generator. But, the reality is that LQS does not possess sufficient funds at present for such  
10 purpose. Nor, will LQS have sufficient funds if the revenue requirement recommended in the  
11 ROO is adopted by the Commission.

12 Further, the ROO chides LQS retrospectively for (i) not having sought Commission  
13 approval to enter into a lease with FMS for the portable 100 kW generator here in question,<sup>3</sup> and  
14 (ii) not having provided a copy of the lease or testimony about the terms of the lease.<sup>4</sup> However,  
15 the reality is that there is no lease as of this juncture. Rather, there is an informal interim  
16 arrangement between LQS and FMS, which was intended to address LQS' system reliability needs  
17 pending LQS' receipt of sufficient funds to purchase a generator.<sup>5</sup> In that regard, after several  
18 years of providing LQS with a generator at no charge, FMS determined that it should be  
19 compensated in the amount of \$1,650 per month (or \$19,800) annually) for LQS' possession and  
20 use of the generator. In turn, LQS concluded that ratemaking recognition of this "real world" cost  
21 of doing business was appropriate, and thus included such a request in LQS' April 26, 2013 rate  
22 increase request.

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25 <sup>3</sup> ROO at page 9, lines 14-15.

26 <sup>4</sup> ROO at page 9, lines 19-21.

27 <sup>5</sup> The ROO appears to assume LQS has decided to use a long-term lease arrangement as the means by which to obtain  
28 access to and use of the necessary portable generator. [ROO at page 9, lines 23-25] In point of fact, a decision of that  
nature has not been made as of this juncture. Critical to any decision as to whether to purchase or lease a generator on  
a long-term basis is the availability to LQS of sufficient funds for such purpose. The revenue requirement  
recommended in the ROO would not result in sufficient funds for either purpose.

1 In connection with the foregoing, it should also be noted that (i) the ROO correctly  
2 observes that the Commission Staff did not provide any evidence rebutting LQS' evidence that the  
3 Company's proposed rental amount was reasonable,<sup>6</sup> and (ii) the ROO itself does not conclude that  
4 the proposed \$1,650 monthly rental expense is unreasonable. Rather, the ROO elects to adopt an  
5 alternative methodology predicated upon an assumed purchase of the generator here in question by  
6 LQS, since that was the scenario contemplated at the time of issuance of Decision No. 69380,  
7 rather than recognize the fact that LQS currently lacks (and has lacked) the funds to make such  
8 purchase.

9 Accordingly, based upon the preceding discussion, the Commission should (i) reject the  
10 \$8,098 annual amount for rental expense for the 100 kW generator recommended by the ROO, and  
11 (ii) adopt the \$19,800 annual amount (or \$1,650 monthly) proposed by LQS.<sup>7</sup> This amount and the  
12 underlying analytical approach for calculating the same more accurately reflect LQS' actual  
13 operating circumstances. In the event that the Commission should in its decision in the Instant  
14 Proceeding also authorize an increase in revenues sufficient to provide LQS with the opportunity  
15 to realize a rate of return on the order proposed by LQS and to purchase a suitable 100 kW  
16 generator, then LQS would be willing to subsequently reduce its rates by \$1,650 per month to  
17 reflect that the rental arrangement with FMS was no longer necessary.

18 **B. The ROO's Recommended Return on Equity, and the Related Recommended**  
19 **Increase in Revenue, Are Not Sufficient to Enable LQS to Attract Capital and to**  
20 **Maintain Ongoing Safe Adequate and Reliable Service.**

21 The "core" of the ROO's recommendation with respect to cost of capital, including the  
22 return on equity to be authorized, would appear to be contained in the following excerpt from page  
23 14, line 17 – page 15, line 11 of the ROO:

24  
25  
26 <sup>6</sup> ROO at page 9, lines 13-14.

27 <sup>7</sup> In that regard, LQS has provided unrefuted testimony in this case that in order to rent a suitable 100 kW generator  
28 from a third party, the annual rental cost would be in the range of \$25,764 to \$51,516. See Exhibit A-5 (November 1,  
2013 Rebuttal Testimony on Rate Base and Income Statement of LQS witness Thomas J. Bourassa at page 12, lines  
22-23).

1 “50. Staff rejected the Company’s argument that Staff’s recommended  
2 return on equity will not provide enough revenue to pay out dividends at a  
3 rate similar to that paid by the sample group. Staff noted that Las Quintas  
4 has had to suspend the Debt Service Reserve portion of the WIFA debt  
5 service and stated:

6 Staff believes getting the Company to a Balanced Capital  
7 Structure Position is the primary issue here. Staff believes  
8 that no consideration should be given to the issuance of a  
9 dividend to Las Quintas shareholders until such time that  
10 the Company’s highly leveraged capital structure becomes  
11 more balanced, either by means of an equity infusion or a  
12 refinancing wherein a portion of the WIFA loan debt is  
13 replaced by newly infused equity capital.

14 51. We agree with Staff that the greater concern is improving the  
15 Company’s capital structure. We note that the Company claimed FMS has  
16 subsidized Las Quintas for several years, asserting this is similar to an  
17 equity infusion. However, for an unknown reason, FMS is no longer  
18 providing Las Quintas with services and equipment for free and the  
19 burden of the costs is being placed on ratepayers. We do not believe it is  
20 reasonable or equitable to require ratepayers to pay even higher rates in  
21 order to provide investors with dividends when the investors have not  
22 contributed any significant equity capital in recent years.

23 52. After consideration of all the testimony, evidence and arguments  
24 presented, we find that Staff’s recommendations are reasonable and we  
25 approve a WACC of 7.7 percent as follows:

	Capital Structure	Cost	WACC
Debt	72.8%	7.2%	5.2%
Equity	27.2%	9.1%	2.5%
Total	100.0%		7.7%

26 Despite giving proverbial “lip service” to the fact that FMS has subsidized LQS for several  
27 years, “saving the Company approximately \$40,000 to \$60,000 annually,”<sup>8</sup> the ROO in reality  
28 effectively ignores that value with its suggestion that FMS has “not contributed any significant  
equity capital in recent years.” That simply is not the case. For example, \$40,000 represents  
approximately 55% of the entire rate increase of \$73,558 which the ROO is recommending be

<sup>8</sup> ROO at page 13, lines 19-23. Also, see Exhibit A-8 (December 4, 2013 Rejoinder Testimony on Cost of Capital of

1 granted in the Instant Proceeding; and, \$60,000 represents approximately 82% of the  
2 recommended increase. Further, those cost savings in the form of maintenance and administrative  
3 support and the 100 kW generator heretofore provided to LQS by FMS at no charge are in reality  
4 the equivalent of cash equity infusions, despite the seeming reluctance of the ROO to acknowledge  
5 and accept that fact.

6 With reference to the reason why FMS at this time "is no longer providing Las Quintas  
7 with services and equipment for free," the answer is quite simple and straight-forward. These  
8 services and equipment ultimately benefit LQS customers and are an integral part of its cost of  
9 providing service. While FMS was willing to financially assist LQS for a period of several years  
10 by providing those services and equipment at no charge, that willingness is neither indefinite nor  
11 open-ended. In that regard, the Instant Proceeding presents both a lawful and timely manner  
12 through which LQS can begin to recover the costs of providing those services to its customers  
13 through increases in its rates and charges moving forward.

14 Further, the Instant Proceeding is both a timely and appropriate means by which FMS and  
15 LQS' other shareholders can be afforded an opportunity to earn a fair and reasonable rate of return  
16 on their investment in LQS. That opportunity does not exist under LQS' current rates and charges  
17 for water service. In addition, such an opportunity will not exist under the Commission Staff's  
18 cost of capital recommendations, as recommended for adoption by the ROO.

19 Although the ROO has adopted Staff's recommended ROE of 9.1 percent, Staff provided  
20 no evidence in the record to demonstrate or explain how its recommended ROE of 9.1 percent  
21 meets the comparable earnings standard and requirement, as set forth in the *Hope* and *Bluefield*  
22 decisions, when:

- 23 1) The average water proxy group's projected ROE is 9.9 percent;
- 24 2) The currently authorized water proxy group's ROE is 10.03 percent;
- 25 3) The NYU Stern School equity-to-debt cost analysis indicates a 12.0 percent
- 26 ROE;

27  
28 LQS witness Thomas J. Bourassa at page 5, lines 12-13).

11 In addition, Staff provided no evidence to refute the testimony of LQS' Cost of Capital  
12 witness Thomas J. Bourassa who (i) provided an analysis of Commission-adopted cost of equity  
13 and cost of debt for Class A and B utilities in Arizona since 2004 and (ii) determined that, based  
14 upon such analysis, the indicated comparable cost of equity for LQS should be at least 11.3  
15 percent.<sup>10</sup>

16 Accordingly, based upon the preceding discussion, the Commission should (i) reject the  
17 ROO's recommendation of a 9.1% cost of equity and a 7.7% weighted average cost of capital for  
18 LQS, and (ii) adopt the 12.5% cost of equity and 8.61% weighted average cost of capital supported  
19 by Mr. Bourassa's testimony.

20 C. The Rate Design Recommended by the ROO (i) Does Not Allocate a Sufficient Portion  
21 of Recovery of the Authorized Revenue Requirement to the Monthly Minimum, and  
22 (ii) Thus Entails a Significant Risk of Continued Revenue Erosion on LOS' System.

20  
27 <sup>9</sup> See Exhibit A-8 (December 4, 2013 Rejoinder Testimony on Cost of Capital of LQS witness Thomas J. Bourassa at page 4, lines 1-18).

10 See Exhibit A-6 (November 1, 2013 Rebuttal Testimony on Cost of Capital of LQS witness Thomas J. Bourassa at page 10, lines 10-13).

1 In the Exceptions filed on July 6, 2011 to the June 28, 2011 ROO in LQS' last rate case,<sup>11</sup>  
2 LQS noted that

3 "The ROO does not consider the potential effect(s) of the proposed rate  
4 design upon LQS' future revenues and LQS' ability to actually realize  
LQS' authorized rate of return under the proposed rates."<sup>12</sup>

5 Succinctly stated, LQS was concerned about the revenue erosion that would occur under the rate  
6 design recommended in the ROO, particularly in view of the fact that LQS' existing rates  
7 incorporated an inverted rate design intended to promote conservation. At that time, LQS' revenue  
8 erosion concern was occasioned by the fact that the rate design recommended by the ROO shifted  
9 certain cost recovery responsibility away from smaller meter sizes to larger meter sizes and larger  
10 volumetric consumption tiers. Despite LQS' expression of concern, the Commission adopted the  
11 rate design recommended in the June 28, 2011 ROO in LQS' last rate case.

12 In his April 23, 2013 Direct Testimony in the Instant Proceeding, LQS Administrative  
13 Manager Omar Mejia testified that LQS' revenue erosion concerns from its last rate case have  
14 proven to be well-founded, as a result of the rate design therein adopted by the Commission.<sup>13</sup>  
15 Accordingly, in the Instant Proceeding, LQS proposed a rate design which increased the amount of  
16 revenue recovery responsibility that was to be allocated to the monthly minimum portion of the bill  
17 for each meter size. In that regard, the proposed percentage of revenue recovery responsibility  
18 increased from 43.41% in LQS' existing rate design to 48.89% in its proposed rate design in the  
19 Instant Proceeding.<sup>14</sup>

20 At page 17, lines 22-23, the ROO states as follows:

21 "We agree with Las Quintas that a portion of the revenue increase should  
22 be allocated to the monthly minimum in order to provide the company  
23 with a more stable revenue stream."  
24

25  
26 <sup>11</sup> Docket No. W-01583A-09-0589.

27 <sup>12</sup> LQS' July 6, 2011 Exceptions at page 14, lines 1-3.

28 <sup>13</sup> Exhibit A-2 (April 26, 2013 Direct Testimony of LQS witness Omar Mejia at page 6, lines 1-11).

<sup>14</sup> Exhibit A-5 (November 1, 2013 Rebuttal Testimony on Rate Base and Income Statement of LQS witness Thomas J. Bourassa at page 19, lines 2-12).



1 However, the allocation percentage increase recommended in the ROO is marginally insignificant  
2 when compared to the percentage allocation which is provided for in LQS' existing rate design.  
3 More specifically, the ROO's proposed allocation of revenue recovery responsibility to the  
4 monthly minimum is 43.50% vis-à-vis the 43.41% provided for in LQS' existing rate design.  
5 Whereas, LQS proposed allocation in the Instant Proceeding is 48.89%, or 5.39% greater than the  
6 ROO's.

7 In addition, compounding the prospect of continued revenue erosion on LQS' system is the  
8 fact that the ROO is recommending commodity rates higher than those recommended by LQS,  
9 even though LQS' recommended commodity rates are predicated on a proposed revenue  
10 requirement substantially higher than the revenue requirement recommended in the ROO.<sup>15</sup> As  
11 Mr. Bourassa testified, LQS' proposed increased monthly minimums were designed to provide  
12 greater revenue stability.<sup>16</sup> Whereas, the proposed monthly minimums and commodity rates set  
13 forth in the ROO will have precisely the opposite effect, namely, ongoing revenue erosion on  
14 LQS' system. In that regard, as Mr. Mejia testified, LQS' certificated service area circumstances  
15 are such that it has extremely limited potential for future customer growth to offset that revenue  
16 erosion which predictably will occur as a result of (i) the higher commodity rates recommended in  
17 the ROO and (ii) LQS' existing conservation-oriented inverted rate design.<sup>17</sup>

18 Accordingly, based upon the preceding discussion, the Commission should adopt the  
19 percentage allocations for revenue recovery responsibility proposed by LQS for both the monthly  
20 minimum and commodity portions of its rates, in order to avoid that revenue erosion which will  
21 otherwise occur on LQS' system, thus effectively denying to LQS a meaningful opportunity to  
22 earn such revenue requirement and rate of return as the Commission ultimately authorizes in the  
23 Instant Proceeding.

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25  
26 <sup>15</sup> See ROO at page 18, line 1 – page 19, line 8 vis-à-vis page 16, line 14 – page 17, line 8.

27 <sup>16</sup> Exhibit A-5 (November 1, 2013 Rebuttal Testimony on Rate Base and Income Statement of LQS witness Thomas J.  
Bourassa at page 20, line 21 – page 21, line 2).

28 <sup>17</sup> Exhibit A-2 (April 26, 2013 Direct Testimony of LQS witness Omar Mejia at page 2, lines 12-22).

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III.

CONCLUSION

For the reasons discussed in Section II above of these Exceptions, LQS respectfully requests that the Commission direct its Hearing Division to modify the ROO so as to (i) adopt LQS' proposed annual amount of \$19,800 as rental expense for the 100 kW portable generator, (ii) adopt LQS' proposed weighted average cost of capital of 8.61% and cost of equity of 12.5%, (iii) adopt LQS' proposed increase in revenues of \$106,171 for a total revenue requirement of \$688,592, and (iv) adopt LQS' proposed percentage allocation of revenue recovery responsibility as between the monthly minimum and commodity rates in connection with the design of rates intended to provide for recovery of the authorized revenue requirement.

Dated this 6<sup>th</sup> day of March, 2014.

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1 of the foregoing will be filed  
2 this 6<sup>th</sup> day of March 2014 with:

3 Docket Control  
4 Arizona Corporation Commission  
5 1200 West Washington Street  
6 Phoenix, Arizona 85007

7 A copy of the foregoing will also be  
8 emailed or mailed this same date to:

9 Lyn A. Farmer,  
10 Chief Administrative Law Judge  
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